Key Takeaways

Skadden

Corporate Governance Series

Key SEC Financial Reporting, Accounting and Enforcement Matters

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On February 2, 2017, Skadden hosted a webinar titled "Key SEC Financial Reporting, Accounting and Enforcement Matters," the third installment of our four-part Corporate Governance Series focused on trends in corporate governance, company management and Securities and Exchange Commission (SEC) compliance. The program addressed topics such as responding to auditor requests for information; accounting for contingent liabilities and insurance recoveries; SEC focus on non-GAAP disclosure; other SEC enforcement trends, including with respect to auditor conduct and internal controls; segment reporting; and insider trading enforcement and compliance. Skadden partner Katherine "Kady" Ashley (mergers and acquisitions; corporate governance), Ernst & Young partner Steven Jacobs (Professional Practice Group), Skadden partner Colleen Mahoney (head of securities enforcement and compliance), and Skadden partner Michael Scudder (litigation, accounting, and government enforcement and white collar crime) conducted the webinar. Key points from the webinar are summarized below.

Auditor Requests for Information

Mr. Scudder and Mr. Jacobs began the webinar by discussing mechanisms by which a company's independent auditor often requests information (beyond representations from management) from outside or in-house counsel regarding potential contingent liabilities. Mr. Scudder set the stage by emphasizing that assessments of contingent liabilities involve important judgment calls, and meetings between auditors and counsel may be necessary to obtain adequate information. Mr. Jacobs noted that auditors often will rely on counsel for the legal judgements underlying contingency assessments and request meetings to corroborate information or probe assertions in attorney audit letters and management presentations. Meetings between counsel and a company's independent auditor have become an important part of substantive audit procedures.

Mr. Jacobs then discussed Accounting Standard Codification (ASC) 450 regarding contingent liabilities, noting that the standard has not changed in many years and that greater emphasis in SEC staff comment letters has been given to disclosures of loss contingencies. The standard which auditors use to determine whether a contingent liability should be disclosed in a company's financial statements generally comprises three categories: whether the contingency is (i) remote, (ii) reasonably possible or (iii) probable. In addition, companies should determine whether a contingency is estimable — either to a precise dollar amount or within a range. If a contingency is considered remote (or a matter which does not have a material impact on a company's financial statements), then it is not required to be disclosed. If a contingency is reason-

ably possible and estimable, then it should be disclosed and accrued if probable. If a contingency is probable or reasonably possible, but not estimable to a precise dollar amount, then it should be disclosed or booked at the best estimate within the range. If a company records liability at the lower end of the range, disclosure generally should include the maximum amount that is reasonably possible of loss.

Following the discussion of ASC 450 and a brief review of attorney audit letters, including the deference that auditors and counsel should give to the American Bar Association (ABA) Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information, Mr. Scudder reviewed the attorney-client privilege and work-product doctrine in the context of auditor requests as well as steps corporate counsel should take to avoid waivers of privilege.

Mr. Scudder noted that the attorney-client privilege protects the substance of legal advice as well as an outside counsel's assessment of likely exposure. If counsel discloses protected communications with management (or substantive legal advice given to management) to an auditor, the case law is relatively settled that such disclosure waives the attorney-client privilege. The standard is different for the work-product doctrine, which protects materials prepared in anticipation of litigation. Counsel would waive the privilege over such materials if the third party to whom disclosure is made is adverse to the counsel's client or if disclosure results in a substantial likelihood that the material will be disclosed to adverse litigants. Since an independent auditor does not have an adverse relationship to the company it audits, disclosure by counsel of materials covered by the work-product doctrine to such auditor would not create a waiver. Consequently, Mr. Scudder advised program participants, when interacting with auditors by phone, to avoid a pure recounting of discussions between counsel and management. Some companies may prefer to execute confidentiality agreements to provide an additional layer of protection from disclosure, but regardless counsel should emphasize the confidentiality of these discussions with auditors. In addition, attorneys generally should opt for telephone conversations with auditors rather than document exchanges and closely follow existing ABA guidance. Mr. Scudder underscored that auditors, recognizing concerns about privilege, typically do not press outside counsel to disclose the precise contents of conversations with management or in-house counsel. Instead, auditors prefer to receive assurance from outside counsel that such counsel has no reason to dispute the client management's presentation or assessment.

Accounting for Contingent Liabilities and Insurance Recoveries

Mr. Jacobs then continued the program by discussing how to disclose contingent liabilities with a probable loss in cases where a company expects an offsetting insurance recovery. U.S. GAAP generally prohibits recording offsetting insurance coverage with a loss contingency on the balance sheet. Not only is an insurance recovery receivable in a company's financial statements allowed only if an insurance recovery is probable, but a company must disclose both the accrued liability and separately the insurance recovery receivable. Mr. Scudder then noted that a company may want to avoid a perception among investors that the company may suffer material, uncovered litigation losses that cannot be offset by insurance, but run into difficulties with the generally accepted accounting principles (GAAP) standard that an asset may only be recorded if recovery is probable because insurance recoveries are frequently disputed and uncertain. Mr. Scudder explained that current law provides flexibility in permitting companies in their financial statements or other public disclosures to make disclosures appropriate under the facts and circumstances about their expected insurance coverage.

SEC Focus on Non-GAAP Disclosure

Ms. Mahoney then discussed trends in the SEC's review of disclosure by companies of non-GAAP financial measures, particularly in the wake of new and revised guidance from the Division of Corporation Finance in May 2016 and related compliance letters. Ms. Mahoney also noted that the SEC's Enforcement Division has looked into non-GAAP disclosure and reportedly conducted a sweep of companies regarding their practices, including with respect to Item 10(e) of Regulation S-K, which requires companies disclosing a non-GAAP measure in SEC filings and earnings releases to also present the most directly comparable GAAP measure with equal or greater prominence. Ms. Mahoney then reviewed recent SEC enforcement actions regarding non-GAAP accounting metrics, including *SEC v. Block* (alleging that two executives, the chief financial officer and chief accounting officer of a publicly traded real estate investment trust, overstated the financial performance of a trust by manipulating the calculation of its adjusted funds from operations, a non-GAAP measure used when the company provided earnings guidance) and *In re MDC Partners Inc.* (alleging that a company failed to afford equal or greater prominence to GAAP measures in earnings releases containing non-GAAP financial measures and that the company failed to inform investors that it had changed the methodology it used to calculate a non-GAAP metric called "organic revenue growth").

Ms. Mahoney underscored that a growing trend in the SEC's enforcement actions and associated litigation has been individual liability for executive officers and consultants of companies found to violate non-GAAP disclosure standards.

Mr. Jacobs then described the main elements of the May 2016 guidance regarding non-GAAP disclosure, noting that many apply to all company communications (*i.e.*, not just earnings releases and required disclosure filings with the SEC). Mr. Jacobs noted that the SEC has been particularly concerned about misleading non-GAAP measures (including exclusion of recurring cash operating expenses or inconsistent disclosure of a measure between fiscal periods), the prominence of non-GAAP measures in disclosures as compared to comparable GAAP measures, and tailored accounting measures (*e.g.*, accelerated recognition of deferred revenue). Mr. Jacobs cautioned companies to revisit their non-GAAP disclosures and consider alternative ways of presenting similar information. If a non-GAAP disclosure must be made, a company should give equal or greater prominence to a comparable GAAP disclosure and clearly explain the usefulness of the non-GAAP disclosure to investors. Companies should reconcile GAAP and non-GAAP measures, implement non-GAAP disclosure controls and provide management's rationale for using non-GAAP measures.

SEC Enforcement Trends

Ms. Mahoney then discussed other SEC enforcement trends in the area of financial reporting, including with respect to auditor conduct and internal controls. She noted that the SEC established a Financial Reporting and Audit Task Force in 2013 to identify financial reporting and accounting cases for the Enforcement Division to pursue. In addition, the SEC launched "Operation Broken Gate" — an initiative to identify auditors who have neglected their duties and required auditing standards. Whistleblowers also have become an important source for the SEC to launch investigations, and the Dodd-Frank Act reforms of the financial services industry included special whistleblower protections (Ms. Mahoney predicted that these protections will remain in place notwithstanding a future repeal of other parts of the Dodd-Frank Act as envisioned by the new Trump administration). Ms. Mahoney discussed how enforcement of financial reporting and accounting practices became an area of high priority for the Enforcement Division during the last administration and, based on the current nominee for SEC chairman, could remain so for the current administration.

Ms. Mahoney then reviewed recent SEC cases involving internal controls over financial reporting (ICFR). The SEC has filed charges where ICFR-related issues are of equal focus in the investigation rather than "add-ons" to other charges like fraud. Some of the recent cases which Ms. Mahoney highlighted include *In re Magnum Hunter Res. Corp.* (charging a company, its chief financial officer, chief accounting officer, audit engagement partner and consultant with ICFR-related violations related to the improper evaluation of the company's control deficiencies and their severity and misapplication of relevant standards for assessing deficiencies and material weaknesses); *SEC v. RPM International Inc.* (charging a company and its general counsel and chief compliance officer with non-scienter fraud reporting, books and records, and ICFR-related violations in connection with the failure to disclose a loss contingency related to a DOJ investigation into whether the company overcharged the government on certain contracts); and *In re General Motors Company* (charging a company with ICFR-related violations for not properly considering loss contingencies and disclosure of potential vehicle recalls for several months after its internal investigation indicated there was a safety issue).

Ms. Mahoney then discussed the SEC's ongoing focus on the conduct of auditors. SEC officials have emphasized that auditor independence remains an area of significant importance. Ms. Mahoney summarized recent cases involving auditors and their activities, including two cases involving Ernst & Young and its violation of independence rules (in those two cases, both the audit firm and individual partners involved in specific matters were charged for the partners' inappropriate relationships with certain of their clients' officers); a case involving BDO USA, LLP (where the audit firm and several partners were charged for ignoring red flags); and a case involving Grant Thornton, LLP (where the audit firm and several partners were charged for ignoring red flags and fraud risks while conducting deficient audits).

Segment Reporting

Mr. Jacobs continued the program with a discussion of segment reporting, including how to identify an operating segment and recent SEC Division of Corporation Finance staff comments. Mr. Jacobs noted that it was important for companies to identify the chief operating decision-maker (CODM) for a particular business segment. He further emphasized that the SEC has begun to take a more holistic view of operating segments, including consideration of organizational structure, budgets, forecasts and executive compensation. Consequently, companies should consider factors outside of the CODM "reporting package" in segment reporting. Mr. Jacobs also addressed the aggregation of operating segments to reportable segments, including similarities in quantitative and qualitative characteristics that should be viewed from the perspective of a reasonable investor. The primary principle companies should consider in deciding whether to report certain information for an operational segment is whether the user of such information would get the same type of information if it was aggregated as if it was separately reported.

Insider Trading Enforcement and Compliance

Ms. Ashley concluded the program by discussing current trends in insider trading enforcement and compliance, including case law, issues companies should consider when crafting insider trading policies, and insider trading enforcement tactics used by U.S. regulatory and law enforcement agencies. Ms. Ashley reviewed the U.S. Supreme Court's holding in *Salman v. United States* that a company insider's gift of confidential information to a "trading relative or friend" is sufficient to establish the personal benefit to the tipper that is required to prosecute the tippee. The Court analogized a gift of confidential information to a trading relative or friend akin to trading by the insider himself followed by a gift of the profits to a tippee. This decision overturns an aspect of the *Newman* case with respect to remote tippees; however, she noted that an element of the *Newman* holding — that the government must prove that the trading defendant knew that the information came from an insider or that the insider received a personal benefit in exchange for the tip — presumably remains good law. This case also raises questions regarding the level of knowledge that must be proven with respect to remote tippees for them to be held liable.

Ms. Ashley then summarized other recent enforcement trends involving failures to enforce internal policies and procedures to prevent disclosure of material nonpublic information. These included a settlement of an administrative action by Deutsche Bank with the SEC involving unauthorized disclosures of nonpublic information to customers and inadequate policies to address interactions between research analysts and trading personnel. Deutsche Bank also settled an action with Financial Industry Regulatory Authority (FINRA) for supervisory failures related to information disseminated through an intercom system. Ms. Ashley noted that FINRA censured Stephens Inc. for lack of supervision over information disclosed in firmwide internal update emails after sensitive information was improperly distributed outside of the company and Stephens' policies to protect such information were found to be inadequate and/or vague.

Ms. Ashley continued the discussion of insider trading enforcement by summarizing common enforcement tactics used by law enforcement and regulatory agencies in their investigations. These include an increasing reliance on public searches of suspects' records, wiretaps of suspects and their relations, observation of traders rather than specific transactions, use of whistleblowers and data analytics, and efforts to bring cases against traders using other peoples' accounts (and seek disgorgement from account holders even if a defendant is not culpable). Some suspects have challenged the use of these tactics. For example, hedge fund manager David Ganek sued the Federal Bureau of Investigation (FBI), the U.S. Attorney for the Southern District of New York and others for raiding his firm's offices and conducting a public search for suspected insider trading in November 2010. Ganek was not charged with a crime, but the publicity surrounding the execution of the search warrant caused irreparable damage to his business operations.

Ms. Ashley concluded the program by discussing insider trading policies and recent compliance trends. She noted that companies are imposing greater restrictions on hedging, pledging and maintaining margin accounts in their policies and are often moving to a reduced timeframe (of one trading day) for markets to absorb information such that it would be deemed "public." Ms. Ashley then reviewed issues that companies should consider in crafting or updating insider trading policies, including the timing of blackout periods, individuals subject to blackout periods, and applicability of the insider trading plan to transactions involving contributions to 401(k) and dividend repurchase plans. She noted that although regular quarterly contributions to a company stock fund in a 401(k) plan may not be subject to policy restrictions, the original instruction for such regular transactions should be subject to blackout and preclearance requirements. Companies are recommended to have rigorous training, monitoring and follow-up in their compliance programs.

Ms. Ashley also discussed recent trends in Rule 10b5-1 trading plans, including repurchase plans, which have become more commonly used. She noted trends in companies utilizing 10b5-1 repurchase plans while also allowing for opportunistic trading outside of the plan. Ms. Ashley advised that while such arrangements are not prohibited by Rule 10b5-1, it is important that close attention be paid to the plan instructions to ensure that the opportunistic purchases do not influence the trades contemplated under the plan. She also advised that other areas requiring close scrutiny in plans include termination rights and triggers. Ms. Ashley recommended legal review of all contemplated 10b5-1 plans.